DOCUMENT RESUME

ED 461 632 SP 040 452

AUTHOR Casabona, Patrick; Shoaf, Victoria
TITLE Recognizing Revenue under SAB 101: A Case Study Approach.
PUB DATE 2001-06-01
NOTE 11p.; Paper presented at the Interactive Teaching Across Disciplines and Cultures Conference (Lund, Sweden, June 17-20, 2001). Contains small print.
PUB TYPE Reports - Descriptive (141) -- Speeches/Meeting Papers (150)
EDRS PRICE MF01/PC01 Plus Postage.
DESCRIPTORS Case Studies; Higher Education; *Income; Teaching Methods
IDENTIFIERS Securities and Exchange Commission

ABSTRACT

The primary cause of enforcement proceedings by the Securities Exchange Commission against U.S. businesses resulted from inappropriate revenue recognition procedures used to inflate income. The concern with revenue recognition improprieties led the SEC to issue Staff Accounting Bulletin No. 101 (SAB 101) in 1999 to clarify existing Generally Accepted Accounting Principles related to revenue recognition. Because of many questions regarding the appropriate application of SAB 101, the SEC published further guidance in the form of a Frequently Asked Questions and Answers (FAQ) document. This paper presents a methodology for teaching some of the most important requirements in SAB 101. The methodology uses questions and answers to introduce the main concepts and principles included in SAB 101 and case study problems to explain the major requirements in SAB 101 and how they are applied in practice. It focuses on key provisions for recognizing revenue under SAB 101, revenue recognition topics covered in SAB 101, and frequently asked questions related to persuasive evidence of an arrangement, delivery and performance, fixed or determinable sales prices, and income statement presentation (gross versus net presentation of revenue in the income statement). An appendix presents six case studies on revenue recognition criteria in SAB 101 and solutions to each case. (SM)

Reproductions supplied by EDRS are the best that can be made
from the original document.

ED 461 632

Recognizing Revenue Under SAB 101: A Case Study Approach

Patrick Casabona, Ph.D.
Associate Professor of Accounting & Taxation
(718) 990-7344
Casabonp@stjohns.edu
(contact and presenter)

and

Victoria Shoaf, Ph.D.
Assistant Professor of Accounting & Taxation
(718) 990-7329
Shoafv@stjohns.edu

St. John's University
Peter J. Tobin College of Business
8000 Utopia Parkway
Jamaica, New York 11439
(718) 990-6461
Fax: (718) 990-1868

Patrick Casabona

1

U.S. DEPARTMENT OF EDUCATION
EDUCATIONAL RESOURCES INFORMATION CENTER (ERIC)
☐ This document has been reproduced as received from the person or organization originating it.
☐ Minor changes have been made to improve reproduction quality.
• Points of view or opinions stated in this document do not necessarily represent official OERI position or policy.

BEST COPY AVAILABLE

SP034453

RECOGNIZING REVENUE UNDER SAB 101: A CASE STUDY APPROACH

Patrick Casabona
Peter J. Tobin College of Business
St. John's University
8000 Utopia Parkway
JAMAICA, NEW YORK 11439, U. S. A.

Victoria Shoaf, St. John's University
Peter J. Tobin College of Business
St. John's University
8000 Utopia Parkway
JAMAICA, NEW YORK 11439, U. S. A.

Abstract

The primary cause of enforcement proceedings by the Securities Exchange Commission (SEC) against U S businesses resulted from inappropriate revenue recognition procedures used to inflate income. The concern with revenue recognition improprieties led the SEC to issue Staff Accounting Bulletin No. 101 (SAB 101) in December 1999, to clarify existing Generally Accepted Accounting Principles related to revenue recognition. Because of many questions regarding the appropriate application of SAB 101, the SEC published further guidance in the form of a Frequently Asked Questions and Answers (FAQ) document. This paper uses a case study approach to explain the major requirements in SAB 101.

INTRODUCTION

During the past decade, the primary cause of enforcement proceedings by the Securities Exchange Commission (SEC) against U S business entities resulted from inappropriate revenue recognition procedures used by companies to inflate income. In September 1998, Arthur Levitt, Chairman of the SEC, delivered a speech which expressed his concern about the increase in earnings management in financial statements from the premature recognition of revenue and other inappropriately applied accounting rules. In addition, a report entitled *Fraudulent Financial Reporting: 1987-1997 An Analysis of U. S. Public Companies*, sponsored by the Committee of Sponsoring Organizations (COSO) of the Treadway Commission, indicated that over half of financial reporting frauds in the study involved overstating revenue. The concern with revenue recognition improprieties led the SEC to issue Staff Accounting Bulletin No. 101 (SAB 101) in December 1999, to clarify existing Generally Accepted Accounting Principles (GAAP) related to revenue recognition to facilitate their implementation in practice. Specific areas of inappropriate revenue recognition procedures that were addressed in SAB 101 included, but were limited to, the recognition of revenue on shipments that never occurred, hidden "side agreements" giving customers nonstandard rights that would affect the appropriate timing of revenue recognition, and shipments of products before customers agreed to delivery. Because businesses and their accounting firms had so many questions regarding the appropriate application of SAB 101, the SEC published further guidance on implementing SAB 101 in October 2000, in the form of a Frequently Asked Questions and Answers (FAQ) document. After several amendments, SAB 101 was finally implemented during the fourth fiscal quarter of fiscal years beginning after December 31, 1999.

In the 2000 financial statements that were issued after SAB 101 was implemented, the most problematic issues of revenue recognition occurred with upfront fees of various types and with formal customer acceptance acknowledgements. Underlying the difference in interpretation of pronouncements regarding these two issues was a fundamental difference in the conception of the earnings process held by the SEC and by accounting practitioners.

It had been customary for practitioners to view the revenue earnings process from the position of the seller. Therefore, practitioners viewed the earnings process as complete when the seller substantially fulfilled his responsibilities and had incurred most of the necessary cost, or when the risks of ownership had transferred to the buyer. In SAB 101, however, the SEC emphasizes its belief that the earnings process should be viewed from the buyer's perspective. Thus, the earnings process should not be considered complete until the buyer has received substantially all of the benefits of ownership.

SAB 101 and the FAQ do not introduce new GAAP rules but only express the SEC staff's interpretation of existing GAAP. Where specific accounting pronouncements exist, the guidance in those pronouncements should be followed. SAB 101 has had an important impact, however, because it made many companies realize that they were not interpreting GAAP in the manner defined in SAB 101. Therefore, a number of firms—including Fortune 100 companies—have reported changes in accounting principle for the year 2000 as a result of implementing the GAAP interpretations presented in SAB 101 and the FAQ. Because SAB 101 does not change existing GAAP, changes resulting from the SAB should have been reported as error corrections, with restatements of prior periods in published financial statements and inclusion of prior period adjustments to the equity section. However, the SEC allowed companies to treat changes due to the interpretations in SAB 101 as changes of accounting principle, which could be reported, in accordance with Accounting Principles Board Opinion No. 20 (APB 20), as a cumulative effect of a change in accounting principles and shown on the income statement. This practice is permitted, however, only if the previous accounting treatment does not actually violate existing GAAP pronouncements. Indeed, most firms have opted to report their 2000 financial statement changes resulting from implementing SAB 101 as changes in accounting principle. However, in the future, changes due to the interpretations in SAB 101 will have to be reported as corrections of errors, requiring restatements of previously issued financial statements, which will have unfavorable effects on the entities' marketability and share value. Because of the importance of this new SEC guidance, the objective of this paper is to present a methodology for teaching some of the most important requirements in SAB 101. This teaching methodology uses questions and answers to introduce the main concepts and principles included in SAB 101 and case study problems to reinforce the major rules and to demonstrate how they are applied in practice.

KEY PROVISIONS FOR RECOGNIZING REVENUE UNDER SAB 101

How does SAB 101 interpret the basic requirements for revenue recognition presented in Statement of Financial Accounting Concepts (SFAC) No. 5, "Recognition and Measurement in Financial Statements of Business Enterprises"?

SFAC 5 indicates that revenue should be recorded: (a) when it has been earned and (b) when it is realized or realizable. SAB 101 specifies that these conditions are met when all of the following criteria are satisfied:

- Persuasive evidence of an arrangement exists.
- Delivery has occurred or services have been rendered.
- The seller's price to the buyer is fixed or determinable.
- Collectibility is reasonably assured.

While the general revenue recognition principles are similar under U.S. GAAP and International Accounting Standard (IASs), now to be issued as International Finanacial Reporting Standards (IFRSs), there are differences in accounting for specific types of revenue transactions. SAS 101's criteria focus more on satisfying the customer than was done in prior practice. Under IAS 18, *Revenue*, revenue is recognized when:

- The significant risks and rewards of ownership are transferred to the buyer.
- The seller retains neither continuing managerial involvement to the degree associated with ownership nor effective control over the goods sold.
- Revenue and any related cost can be measured reliably.
- It is probable that the economic benefits related to the transaction will flow to the enterprise. [IAS 18.14]

The differences in the ability to recognize revenue for certain transactions under U.S. GAAP and IFRSs can have a significant impact on a company's financial statements. These differences generally affect the timing of recognition in a company's financial statements. Under U.S. GAAP, for example, a layaway sale is not recorded as revenue until the goods are delivered. Under IAS No. 18, revenue may be recognized earlier from a layaway sale, assuming a "significant" deposit is received and the product to be sold is identified and segregated.

REVENUE RECOGNITION TOPICS COVERED IN SAB 101 AND FREQUENTLY ASKED QUESTIONS

The SEC addresses specific topics from each of the conditions that it specifies for revenue recognition and one additional topic regarding income statement presentation. The issues addressed are:

- Persuasive evidence of an arrangement (SAB 101—Questions 1 and 2), which includes:
  - Side arrangements.
- Delivery and performance (SAB 101—Questions 3–6 and FAQ Questions 1–9), which includes:
  - Determining when delivery has occurred.
  - Bill-and-Hold agreements.
  - Layaway arrangements.
- Fixed or determinable sales price (SAB 101—Questions 7–9), which includes:
  - Nonrefundable up-front fees (FAQ—Questions 10–13).
  - Set-up service fees (FAQ—Questions 14–17).
  - Refundable membership fees (FAQ—Questions 18–23).
  - Reasonable and reliable estimates of returns (FAQ—Questions 24–27).
  - Contingencies (FAQ—Question 28).
- Income statement presentation (SAB 101—Question 10 and FAQ—Questions 29–30), which covers:
  - Gross versus net revenue recognition (EITF 99-19).

PERSUASIVE EVIDENCE OF AN ARRANGEMENT EXISTS

The first condition for revenue recognition is that "persuasive evidence of an arrangement" exists. This condition requires that there should be a contractual agreement between the seller and the buyer that specifies the terms of the deal—either a written contract or some other documentation that is binding on the customer. SAB 101 identifies "arrangement" as the final understanding between the parties as to the specific nature and terms of the agreed upon transaction. Note that the contract can be modified by "side agreements" that change the terms of the arrangement. The terms of the side agreement, if agreed upon subsequent to the formal contract, would become the final understanding between the parties and thus would determine the nature of the arrangement. The existence of side agreements may indicate that the original agreement was not final and revenue recognition was not appropriate.

Cases No. 1 and No. 2 in Appendix A explain how these aspects of the first criterion in SAB 101 should be applied in practice.

DELIVERY AND PERFORMANCE

SAB 101 specifies that one of the conditions for revenue recognition is that delivery has occurred or services have been rendered. The two indicators for determining whether delivery has occurred or services have been rendered are (1) whether the customer has accepted substantially all of the risks and rewards associated with the product sold or the service rendered, and (2) whether the seller has substantially completed or fulfilled the terms specified in the arrangement in order to earn the right to the proceeds from the sale. Delivery generally is not considered to have occurred unless the product has been delivered to the customer's place of business or another site specified by the customer. If the customer specifies an intermediate site but a substantial portion of the sales price is not payable until delivery is made to a final site, then revenue should not be recognized until final delivery has occurred. Delivery has not occurred unless the customer has taken title to the product.

Is it ever possible for the seller to recognize revenue before delivery of the goods to the customer?

Revenue can be recognized in a "bill and hold" situation, even when delivery has not occurred, if specific criteria are met. These include completion of the goods and their segregation from other goods in the seller's warehouse; the buyer's request for the seller to hold the goods; and the determination of a delivery date. However, these criteria do not override previous requirements for revenue recognition.

Other conditions that might impede revenue recognition even though goods have been delivered according to the basic guidelines include improper formal customer acceptance, uncompleted contract terms, multiple deliverables (and other multiple element arrangements), and consignment arrangements. In general, if the customer has the unilateral right to cancel prior to signing off, revenue recognition is not appropriate without formal acceptance. The SEC staff presumes that such contractual customer acceptance provisions are substantive, bargained-for terms and accordingly, the seller should generally not recognize revenue until customer acceptance occurs or the provisions lapse.

Under the original guidance of SAB 101, it was implied that if a firm received 90% up front and 10% upon installation, the firm could not recognize the 90% until installation, even though it was routine. However, the FAQ (No. 2) clarifies that revenue can be recognized if the remaining obligation is inconsequential or perfunctory. If revenue is recognized, the costs expected to be incurred to fulfill the obligation must be reliably estimable and accrued.

What factors would indicate whether an item was inconsequential or perfunctory?

In general, the remaining item is not considered inconsequential or perfunctory if:

- The remaining obligation is essential to the functionality of the product or service.
- Failure to complete the activities would result in full or partial refund or rejection of products or services delivered to date.
- The seller has no history of completing the remaining tasks in a timely fashion and reliably estimating their cost, or the cost or time to perform the remaining obligations has varied considerably.
- The payment of a large portion of the sales price coincides with delivery (performance) of the remaining activity.
- A lengthy period of time is required to perform remaining obligation (impacting the ability to reliably estimate costs).

MULTIPLE ELEMENT ARRANGEMENTS

Does the failure to deliver all elements of sales arrangement always preclude immediate recognition of any revenue or can certain elements of the arrangement recognize revenue at different times?

The FAQ provides the following criteria for recognition of revenue for partial completion of multiple element arrangements. In order to recognize revenue on delivered elements prior to delivery of all elements, each element must meet these criteria:

- Each element is a separate earnings process.
- The seller must have reliable, verifiable, objective evidence of the fair values of all elements.
- An undelivered element must not be essential to functionality of delivered elements.
- The amount payable for delivered elements is not forfeitable.

According to EITF 00-21, "Accounting for Revenue Arrangements with Multiple Deliverables", a revenue arrangement with multiple deliverables should be divided into separate units of accounting based on the deliverables in the arrangement if all of the following criteria are met:

- The deliverable(s) in the arrangement that has been delivered represents a separate earnings process. Paragraph 83(b), footnote 51, of Concepts Statement 5; Question 5 of SAB 101; and Question 4 of the FAQ contain guidance regarding the earnings process,
- Any undelivered item(s) in the arrangement is not essential to the functionality (based on the guidance in paragraph 9) of the deliverable(s) in the arrangement that has been delivered, and
- There is objective and reliable evidence of fair value to allocate the arrangement consideration to the deliverables in the arrangement in accordance with paragraphs 11-13.

If any of the criteria above are not met, the delivered item(s) being evaluated would not qualify to be a separate unit of accounting within the revenue arrangement. Instead, that deliverable would be combined with the other applicable deliverable(s) within the arrangement. The appropriate revenue recognition then would be determined for those combined deliverables as a single revenue accounting unit. If it is appropriate to recognize revenue upon completion of an element in a multiple element arrangement, revenue is allocated based upon a measure of fair value.

If a customer is not obligated to pay a portion of the contract price allocable to delivered equipment until installation (or other similar service), must recognition of revenue on the delivered equipment always be deferred until that service is performed?

A determination must be made about whether the installation is essential to the functionality of the delivered equipment. It was commonly inferred from SAB 101 that it was always necessary to defer revenue until installation, but the FAQ indicates that this is not always the case. If the installation is not essential to the functionality of the equipment—because the equipment is standard, the installation service is available elsewhere and does not alter the equipment's capabilities—then revenue may be recognized before installation. According to EITF 00-21 (paragraph 9), indicators that an undelivered item(s) may be essential to the functionality of other deliverables in the arrangement that have been delivered include:

- The undelivered item(s) involves significant changes to the features or capabilities of the delivered item(s).

- The undelivered item(s) involves building complex interfaces or connections.
- The undelivered item(s) is unavailable from other vendors.

Conversely, examples of indicators that an undelivered item(s) may not be essential to the functionality of other deliverables in the arrangement that have been delivered include:

- The undelivered item(s) does not significantly alter the capabilities of the delivered item(s).
- The delivered items are standard products or services.
- Other companies are available to perform the undelivered services or provide the undelivered products.

Inconsequential or perfunctory deliverables are described in EITF 00-21 (paragraph 10). A vendor should assess all deliverables in an arrangement to determine if they qualify under this Issue to be separated into multiple units of accounting. If so, they should be accounted for as separate units of accounting. Nevertheless, a vendor may adopt a policy of excluding a deliverable from the revenue accounting for an arrangement and recognizing the cost of the excluded deliverable as a liability if it meets all of the following conditions:

1. The deliverable is not essential to the functionality (based on the guidance in paragraph 9 in EITF 00-21) of other deliverables in the arrangement that have been or will be delivered before the deliverable being evaluated.
2. The deliverable is inconsequential or perfunctory. In order to consider the deliverable inconsequential or perfunctory, the vendor should have a demonstrated history of providing the deliverable in a timely manner and reliably estimating the cost of providing that deliverable.
3. Any vendor obligation relating to nonperformance (failure to provide the deliverable being evaluated) would not result in a refund, revenue reversal, or concession greater than the liability recognized for the cost of the inconsequential or perfunctory deliverable.

When revenue is first recognized for a deliverable in the arrangement, the cost of any inconsequential or perfunctory deliverable(s) that has been excluded from the revenue accounting should be recognized as a liability. Case No. 3 in Appendix A gives the reader the opportunity to identify issues related to multiple element arrangements (discussed in detail in EITF 00-21).

FIXED OR DETERMINABLE SALES PRICE

Can nonrefundable, up-front payments be recognized as revenue when they are received?

It depends on the facts on a case-by-case basis. Nonrefundable up-front payments generally should be evaluated from the perspective of the customer. If the customer expects the continuing involvement of the seller or if the up-front payment covers a single element of a multiple-element arrangement, then revenue should be recognized over the period of use to the customer. The pattern of incurring costs is not necessarily determinative of revenue recognition. If it is determined that an up-front fee should not be recognized immediately, then the expected term of the arrangement is the appropriate period over which to recognize the revenue.

What factors should a seller consider in assessing whether an up-front fee is recognizable as revenue or must be deferred?

The factors that a seller should consider include:

- What is the earnings process, and when does it culminate?
- Is the undelivered or unperformed obligation essential to the functionality of the performance or product for which the up-front payment is ostensibly received?
- Is the substance of the arrangement a situation where the purchaser is paying for a service that is delivered over time?
- From the customer's perspective, what is being purchased?

Cases No. 4 and No. 5 in Appendix A demonstrate how the SAB 101's rules related to up-front fees should be applied in practice.

SAB 101's third criterion for revenue recognition is that the seller's price to the buyer is fixed or determinable. How does the right of return affect the sales price?

The sales price in arrangements that are cancelable by the customer are neither fixed nor determinable until the cancellation privileges lapse. If the cancellation privileges expire ratably over a stated contractual term, the sales price is considered to become determinable ratably over the stated term. Short-term rights of return, such as thirty-day money-back guarantees, and other customary rights to return products, are not considered to be cancellation privileges, but should be accounted for in accordance with SFAS No. 48, with a provision for any costs or losses expected in connection with returns made on the date of sale and excluded from sales and cost of goods sold in the

income statement and deducted from trade accounts receivable in the balance sheet or recorded as a liability if sales have been made for cash.

How should sellers recognize revenue for membership fees paid fully at the outset of an arrangement, when the customer has the unilateral right to cancel the arrangement at any time during its term and receive a full refund of the initial fee?

SAB 101 indicates that registrants can follow one of two models for recognizing revenue when refunds are expected:

1. If specific criteria as outlined in question #7 of SAB 101 are met, then the seller should recognize revenue net of estimated refunds under a model similar to that in SFAS 48, *Revenue Recognition When Right of Return Exists*.
2. SFAS 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, can be applied, where the seller recognizes revenue when the refund provision lapses. (This is the preferable method.) Whatever the selected method is, it must be properly disclosed and consistently applied.

What are the specific criteria discussed in question #7 of SAB 101 required in order to apply a model similar to SFAS 48 for service transactions?

To recognize revenue with an allowance for refunds, all of the following requirements must be met:

- The population of transactions is a large pool of homogeneous items (e.g., membership or other service transactions with the same characteristics such as terms, periods, class of customers, nature of service, etc.).
- Reliable estimates of expected refunds can be made on a timely basis.
- There is a company-specific historical basis to estimate refunds.
- The amount of the initial sale or fee is fixed at the outset of the arrangement

Case No. 6 illustrates how SAB 101's rules for refundable fees should be applied in practice.

FINANCIAL STATEMENT PRESENTATION

How should accounting changes made as a result of SAB 101 be shown on the financial statements?

Because SAB 101 does not change existing GAAP, changes resulting from the SAB should be reported as either a change in accounting principle (if the change is from an acceptable method to a preferred method) or as a correction of an error (if the change is from an unacceptable method).

Management's Discussion and Analysis (MD&A) should discuss revenue, including unusual or infrequent transactions, known trends or uncertainties that have had, or might reasonably be expected to have, a favorable or unfavorable material effect on revenue, operating income or net income and the relationship between revenue and the costs of the revenue. Changes in revenue should not be evaluated solely in terms of volume and price changes, but should also include an analysis of the reasons and factors contributing to the increase or decrease.

Gross Versus Net Presentation of Revenue in the Income Statement

What guidelines should a company use to determine that it should report revenue on the income statement based on the gross amount billed to a customer because it has earned revenue from the sale of the goods or services?

In order to recognize the gross amount as revenue, the criteria in EITF No. 99-19, "Reporting Revenue Gross as a Principal versus Net as an Agent", should be satisfied.

EITF 99-19 provides various criteria deemed to be indicators of whether to report revenue as a principle gross or net as an agent reporting, but states that they should not be considered presumptive or determinative.

The indicators of gross reporting are:

- The company is the primary obligor in the arrangement.
- The company has general inventory risk (before customer order is placed or upon customer return).
- The company has latitude in establishing price.
- The company changes the product or performs part of the service.
- The company has discretion in supplier selection.
- The company is involved in the determination of product or service specifications.
- The company has physical loss inventory risk (after customer order or during shipping).
- The company has credit risk.

The indicators of net reporting are:

- The supplier (not the company) is the primary obligor in the arrangement.
- The amount the company earns is fixed.
- The supplier (and not the company) has credit risk.

In addition, SAB 101 indicates that the company:

- Acts as a principal in the transaction.
- Takes title to the products.
- Has risks and rewards of ownership, such as the risk of loss for collection, delivery, or returns.

If the company performs as an agent or broker (including performing services, in substance, as an agent or broker) without assuming the risks and rewards of ownership of the goods, sales should be reported on a net basis.

CONCLUSION

As we have seen, the SEC's SAB 101 and its FAQ guidance have had a profound effect on how accounting practitioners will interpret and apply GAAP rules for recognizing revenue in financial statement in the future. Hopefully, this new guidance will help reduce "earnings management" techniques related to revenue recognition and other related acts of fraud used to skillfully deceive the readers of financial statements. As we have seen, SAB 101 applies a different perspective to questions of revenue recognition than that previously used in accounting practice. It requires companies to view transactions from the perspective of the buyer of goods and services, rather than from their own perspective, in making determinations about recognizing revenue. The result is that many companies have had to change their current business practices and to report changes to revenues recognized in previous years to reflect this new perspective. Thus, this change in interpretation—which does not change GAAP—has had a widespread effect in practice. The case-study methodology, which was supported by key questions and answers that were presented in this paper, is an effective way of communicating these important concepts to individuals that are interested in learning them.

APPENDIX A: CASE STUDIES ON REVENUE RECOGNITION CRITERIA IN SAB 101

Case No. 1

CompCalc Company is a manufacturer of calculators. CompCalc received an order from Abet Company for 600 calculators on December 20, 2002, and agrees to ship the calculators before December 24 to arrive at Abet's facilities before the New Year's sale. As a result, CompCalc ships the computers on December 23rd, even though it does not receive the written sales agreement that is customary for sales of this nature, with signatures of the authorized representatives of Abet, until January 2, 2003. How much revenue should CompCalc recognize from the sale in 2002?

Solution to Case No. 1

SAB 101 indicates that, if it is customary to obtain a written sales agreement, then persuasive evidence of an arrangement requires a final agreement that has been executed by the properly authorized personnel of the customer. Therefore, CompCalc has not received the customary written sales agreement, even though delivery has been made. Since there is not persuasive evidence of the arrangement, revenue recognition is not appropriate until the agreement is complete.

Case No. 2

Micronics Company is a manufacturer of personal computers. ABC Inc., places an order with Micronics for 2,500 PCs on December 15, 2002, after completing the written agreement that is customary for sales of this nature, with signatures of the authorized representatives of the company. The computers are shipped and billed on December 16, 2002. ABC is a little short on cash, since it is a new company. Therefore, the president of Micronics agrees to allow it to pay Micronics for the PCs after 500 of them have been sold. ABC sells a total of 500 computers on January 20, 2003, and provides the full payment to Micronics at that time. How much revenue should Micronics recognize from this sale in 2002?

Solution to Case No. 2

Given the above facts, it is clear that Micronics' president has made a "side agreement" with ABC Inc. that changes the nature of the agreement. In fact, it even raises questions about whether or not persuasive evidence of an arrangement exists. The new agreement represents a type of financing for ABC, which would resemble a

consignment, rather than a sale (as described in SAB 101), if the unsold computers were returnable. This type of "side agreement" raises questions about the certainty of collection, as required for revenue recognition in SFAC No. 5. Revenue recognition is generally precluded if the buyer's obligation to pay is contractually or implicitly excused until the buyer resells the product. Therefore, revenue recognition should be deferred until XYZ receives payment for the PCs.

Case Study No. 3[1]

TriComputer Manufacturing Corporation signed a sales contract with Custom Arc Company for $4,000,000 of its high-tech computer equipment. Title to the computer equipment passes to the customer upon delivery and the contract indicated that installation of the equipment would be free. The value of these installation services, which are normally sold separately, is about $500,000, and the cost to TriComputer is about $200,000. Normal practice for TriComputer is to install the equipment in about 50 days from the date of delivery of the computer equipment. However, installation can be performed by others. The entire contract price must be paid 50 days after delivery. TriComputer recognizes revenue when the computer equipment is shipped.

Given the above facts, can TriComputer recognize revenue after delivery and be in conformity with the guidance in SAB 101, FAQ, and EITF 00-21? As you answer this question, also evaluate any specific issues, such as whether or not the installation of the equipment is inconsequential or perfunctory to its sale or whether or not the sale of the computer equipment can be separated from its installation when recognizing revenue.

Solution to Case No. 3

1. Based on the following analysis, it is difficult to assume that the installation services are inconsequential or perfunctory to the sale. The cost of completing the installation to TriComputer is $200,000, which, compared to the fair value of the services of $500,000, is significant and the fair value of these services is not inconsequential relative to the entire contract price. Although TriComputer normally installs the equipment as promised, it may take up to up to 50 days (which is a relatively long period of time). Payment is due after the expected completion of installation, but it is not contingent upon successful installation. Note that if the installation is not completed, we would need to know if and how the agreed upon price of the contract would be reduced (i.e., by an amount equal to the fair value of the installation) in order to recognize revenue.

2. TriComputer may not be able to separate revenue recognition for the sale of the equipment from the installation service revenue, based on the following analysis.

The company can and has sold the computer equipment without the installation services and can sell the installation services without the computer equipment. This provides objective evidence for determining the fair value of both elements of the contract. Since title to the computer equipment passes on shipment, and other entities can perform the installation if TriComputer cannot, this is favorable to revenue recognition under SAB 101.

However, the facts of this case study do not indicate whether the customer can use the product prior to installation, although other vendors are available to provide the installation services. Therefore, there is not sufficient information available to determine whether installation is essential to the functionality of the computer equipment. Thus, it is difficult to make a conclusion without further information, if the recognition of revenue is appropriate at this time.

Note that prior to SAB 101, practitioners would probably have recognized revenue related to the computer equipment upon shipment and deferred a portion of the revenue related to installation. However, revenue recognition under SAB 101 is more difficult to determine and justify.

Case No. 4

Helltele Company sells proprietary electronic products to customers under long-term combined license and supply contracts, which allow customers the right to both use and sell the products. In the event that Helltele fails to supply the product, it must grant the customer (or a third party) a license to manufacture the product. Helltele does not enter into product license agreements without concurrently entering into a supply agreement for that product. The contracts include an up-front nonrefundable fee assigned to the license. Other amounts are paid as products are supplied at prices established at the initiation of the contract. Should the up-front fee be recognized as revenue under this arrangement?

---

[1] This case was adapted from Course 10-7050, "Partners and Directors Technical Excellence Seminar, Deloitte & Touche, LLP, New York, N. Y., 2000.

Solution to Case No. 4

The up-front fee would not be recognized as revenue at the inception of the license and supply agreement because the earnings process is not complete, resulting from the seller's significant continuing involvement. In addition, the license and supply agreements are difficult to separate because a license agreement is always accompanied by a supply agreement. As such, there is not sufficient verifiable objective evidence of the fair value of the two elements of the transaction.

The customer appears to have paid the up-front fee for the on-going right to obtain and sell the products deliverable under the license and supply agreement. Therefore, the up-front fee should be deferred and recognized over the term of the supply contract.

Case No. 5

MaBell is a local telephone company that charges customers an activation fee for local phone service and then charges them monthly for usage. A customer who has already been using MaBell for several years orders the installation of an extra phone jack. How should MaBell recognize revenue from the installation of the additional jack?

Solution to Case No. 5[2]

According to the FAQ, revenue could be recognized upon installation because ongoing service is unaffected by the number of phone jacks. This service is provided to customers in instances when they are not activating service. In addition, customers could choose another installer or install it themselves.

According to the FAQ, the installation of the additional jack is considered a separate and discreet earnings process. Note that if this service were incurred with installation of basic phone service, it would have to be deferred. In addition, it would be part of a multiple element arrangement and would be impacted by the requirements in EITF 00-21.

Case No. 6

Electron Company opens a store on October 1, 2002, in which customers can use its electronic office equipment for $20 per hour. Electron also sells $5,000, one-year memberships, which allow customers 20 hours of time on the equipment each month. Customers can cancel the memberships any time within the first six months and receive a pro-rata refund for the remaining time of the membership. How much revenue should Electron recognize for the membership fees in its financial statements for the year 2002?

Solution to Case No. 6[3]

The membership fees do not satisfy SAB 101's requirements for recording refundable membership fees, net of estimated refunds because there is no company-specific basis upon which to estimate the refunds. However, since refunds are made on a pro-rata basis for the unused portion at the time of the refund, Electron Company need not wait until the end of the refund period to recognize revenue. Once a month has passed, that portion of the membership fee is no longer refundable. Thus, Electron Company can recognize revenue monthly for the month's allocation of memberships still in force, assuming all other revenue recognition criteria are satisfied.

REFERENCES

American Institute of Certified Public Accountants, 1971, *Accounting Principles Bulletin No. 20, Accounting Changes*, New York, AICPA.

Committee of Sponsoring Organizations, 1999, *Fraudulent Financial Reporting: 1987-1997 An Analysis of U. S. Public Companies,* New York, Committee of Sponsoring Organizations of the Treadway Commission.

Levitt, A., 1998 (September 28), "The 'Numbers Game'," www.sec.gov/news/speech/speecharchive/1998speech .

Securities and Exchange Commission, 1999, *Staff Accounting Bulletin No. 101: Revenue Recognition in Financial Statements* (and Amendments SAB 101A and SAB 101B), www.sec.gov/interps/account .

[2] This case was adapted from Course 14-4007, "Advanced Revenue Recognition", Deloitte & Touche, LLP, New York, N. Y., 2001.

[3] This case was adapted from Course 14-4007,op. cit.